Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:TL-N-4165-00
RAVarra

date:

to: Manager, Group 4209
Attn: Charles D. Atkinson

from: Associate Area Counsel, LMSB, Denver

subject: **Request for Advisory Opinion**
Qualified Reinvestment under I.R.C. § 1071
Taxpayer: [redacted] (formerly [redacted])

We are writing in response to your memorandum requesting our advice regarding the taxpayer's claim that an investment qualifies as a reinvestment under I.R.C. § 1071.

ISSUE

Whether a series of transactions engaged in by the taxpayer constitutes a qualified reinvestment under I.R.C. § 1071, and, if it does, to what extent does it qualify.

CONCLUSION

The debt assumptions and conversion of debt into preferred stock in this case can be disregarded under the step transaction doctrine. The only investment made to purchase the replacement property was the $[redacted] that [redacted] paid to acquire the common stock of [redacted] The steps taken to give the appearance of an additional $[redacted] of consideration were transactions in form only, with no economic substance.

FACTS

[redacted], formerly known as [redacted] is the parent corporation of a consolidated group. The parent corporation is referred to herein as "[redacted]" and the consolidated group is referred to herein as "the taxpayer". On [redacted] one of [redacted]'s wholly owned subsidiaries, [redacted] (hereinafter "[redacted]") sold the assets of a [redacted] known as [redacted] for $[redacted] realizing a taxable gain of $[redacted]. The Federal Communications Commissioner issued a certificate indicating that this sale was necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the FCC with respect to the ownership or control of [redacted]. Pursuant to I.R.C. § 1071, the taxpayer elected to defer recognition of the gain on the sale as an involuntary conversion under I.R.C. § 1033. After this sale, [redacted] reported distributing $[redacted] as a dividend to [redacted], leaving [redacted] with a negative net book value of $[redacted].

On its [redacted] income tax return, the taxpayer reported the purchase of stock in [redacted] (formerly known as [redacted]), a company engaged in [redacted] in [redacted], as replacement property. The return indicates that the stock was purchased on [redacted], for $[redacted]. The taxpayer reported gain of $[redacted] as depreciation recapture, and total deferral of $[redacted], with the replacement property having a basis of $[redacted].

A new corporation, called [redacted], was formed in [redacted] by [redacted] and [redacted]. [redacted] is unrelated to the taxpayer. [redacted] was a wholly owned subsidiary of [redacted], which is a wholly owned subsidiary of [redacted].

[redacted] was initially capitalized with [redacted] shares of Class A Common Stock and [redacted] shares of Class B Common Stock. The Class A shares were all held by [redacted] and the Class B were all held by [redacted]. The Class A shares were entitled to [redacted] votes per share and the Class B shares were entitled to [redacted] vote per share. The rights of the different classes of stock were otherwise the same. This gave [redacted] a [redacted]% equity interest in [redacted], but only a [redacted]% voting interest.[1] [redacted] and [redacted] obtained these shares through capital contributions of $[redacted] per share.

On [redacted] acquired [redacted] the [redacted] in [redacted], for $[redacted]. To finance this acquisition, [redacted] borrowed $[redacted] from [redacted], as follows: 1) $[redacted] as a Term Loan at [redacted]%, 2) $[redacted] as a Zero Coupon Loan at [redacted]%, and 3) $[redacted] as a Revolving Loan at [redacted]%. [redacted], obtained the funds to make

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[1] The taxpayer included [redacted] as part of the consolidated group on its returns. In a prior audit cycle covering the years [redacted] through [redacted], claimed losses from [redacted] of $[redacted]; $[redacted]; $[redacted] and $[redacted] for the years [redacted], [redacted], and [redacted] respectively, were disallowed on the consolidated return because the [redacted]% ownership test for affiliation under I.R.C. § 1504 was not satisfied.

these loans to [redacted] through a combination of a public debt offering and bank financing.

[redacted] arranged the financing of the [redacted] purchase in exchange for [redacted] entering into a sharholders agreement. [redacted], and [redacted] executed the shareholders agreement on [redacted], which granted each shareholder a right of first refusal if the other party wanted to sell their shares and contained options and puts for [redacted]'s Class A stock. Under the agreement, [redacted] had an option to purchase the Class A shares for a [redacted] year period beginning [redacted] years after acquisition of [redacted]. The agreement also gave [redacted] a put, under which he could require [redacted] to purchase the Class A shares during this period. The price of the Class A shares under both the option and the put was the greater of the Class A shareholder's equity as shown on the books or $[redacted].

Both [redacted]'s [redacted] shares of Class A stock and [redacted]'s [redacted] shares of Class B stock in [redacted] were pledged as security for Senior Secured Debt that [redacted] owed to various banks. The notes for the Term Loan, Zero Coupon Loan, and Revolving Loan held by [redacted] from [redacted] were also pledged as security for this indebtedness.

[redacted], agreed to modify the shareholders agreement of [redacted] in exchange for $[redacted]. The agreement, dated [redacted], indicates that it was executed by [redacted]; [redacted]; and [redacted] plus [redacted] (a newly formed subsidiary of [redacted]); [redacted] (a newly formed subsidiary of [redacted]); and [redacted].[2] In the modification, [redacted] acknowledged that [redacted] had no net worth or shareholder's equity. The modification allowed [redacted] to acquire [redacted] of [redacted]'s class A shares in [redacted] for $[redacted] and authorized [redacted] to exchange his remaining [redacted] shares for [redacted] Class A shares of [redacted] held by [redacted]. The agreement gave [redacted] the right to purchase and [redacted] the right to require [redacted] to purchase the [redacted] shares on or before [redacted]. The agreement further indicated that [redacted] was contemplating a potential restructuring of its subsidiaries' debts and assets.

An involuntary petition under Chapter 11 of the Bankruptcy Code was filed against [redacted] on [redacted]. [redacted] ultimately

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[2] It appears from later documents, as discussed below with respect the the [redacted], transactions, that [redacted] and [redacted] were not created as newly incorporated entities at this time, but came into existence through mere name changes for [redacted] and [redacted], respectively, on [redacted].

consented to the bankruptcy and an order for relief was entered on [redacted]. All of [redacted]'s subsidiaries, except [redacted] were also in bankruptcy and the cases were jointly administered. A Plan of Reorganization was confirmed in [redacted].

On [redacted], the following series of transactions was effected:

- [redacted] purchased [redacted] shares of [redacted] Class A stock from [redacted] for $[redacted];
- [redacted] made a capital contribution of the [redacted] shares of [redacted] Class A stock to [redacted]
- [redacted] sold the [redacted] Class A shares of [redacted] stock, plus the [redacted] Class B shares of [redacted] stock it held to [redacted] for $[redacted]
- [redacted] assumed $[redacted] of the $[redacted] debt owed by [redacted] to [redacted], reflected as a contribution of capital from [redacted] to [redacted], [redacted];
- [redacted] assumed the same $[redacted] of debt from [redacted] to [redacted], reflected as a contribution of capital from [redacted] to [redacted];
- [redacted] exchanged $[redacted] of the debt owed it from [redacted] for a $[redacted] note and $[redacted] in newly issued [redacted] preferred stock;[3]
- [redacted] forgave the remaining $[redacted] (all of which was accrued interest) due from [redacted];

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[3] The note provided for interest at [redacted]% above an index rate (for a total of [redacted]% on [redacted]). The interest was to be added to principal or paid quarterly, partially or in full, at the debtors option. A balloon of the full amount then due on the note was due on [redacted]. Upon a sale of all or substantially all of the assets of the debtor, net sales proceeds were to be applied to the note. The preferred stock bore an [redacted]% dividend rate. The stock could be redeemed by the issue at any time, and, upon the sale of all or substantially all of the asset of the issuer, had to be redeemed out of available funds after repayment of the note.

- [redacted] sold the [redacted] shares of Class A and [redacted] shares of Class B [redacted] stock, plus the $[redacted] of [redacted] preferred stock to [redacted] for $[redacted]
- [redacted] issued a $[redacted] note payable to [redacted] for the purchase of [redacted] common and preferred shares[4].
- [redacted] changed its name to [redacted], and [redacted] changed its name to [redacted].

Attached at the end of this memorandum are charts reflecting the corporate structure before and after these transactions.

On their books, [redacted] and [redacted] had reported that $[redacted] and $[redacted] of interest for the years [redacted] and [redacted], respectively, due [redacted] to [redacted] was being written off as interest that would never be paid.

We understand that, subsequent to [redacted], the remaining [redacted] shares of [redacted] held by [redacted] were acquired and later [redacted] or the assets of [redacted] were sold.

ANALYSIS

Under former I.R.C. § 1071[5], a taxpayer could elect to treat the sale or exchange of property as an involuntary conversion under I.R.C. § 1033 if the Federal Communication Commission (FCC) certified that the sale or exchange was necessary to effectuate a change in a policy or adoption of a new policy of the FCC. I.R.C. § 1071(a). Under I.R.C. § 1033, gain is recognized on an involuntary conversion into money only to the extent that the taxpayer fails to use the amount realized from the conversion to purchase replacement property within two years from the end of the first taxable year in which any part of the

[4] The note provided for interest at [redacted]% above an index rate (for a total of [redacted]% on [redacted]). The interest was to be added to principal or paid quarterly, partially or in full, at the debtors option. A balloon of the full amount then due on the note was due on [redacted]. Upon the receipt of proceeds from the sale of all or substantially all of the [redacted] assets or a distribution in respect of the [redacted] stock, net sales proceeds were to be applied as prepayments on the note.

[5] This section was repealed for sales and exchanges after January 17, 1995, and sales and exchanges before that date if the F.C.C. tax certificate was issued on or after January 17, 1995. P.L. 104-7, § 2(a). All references to I.R.C. § 1071 hereinafter refer to that section as it was in effect prior to repeal.

gain from the conversion is realized. I.R.C. § 1033(a)(2). In this case, the FCC issued the necessary certification and the taxpayer made the necessary election under I.R.C. § 1071. The taxpayer therefore satisfied the requirements in I.R.C. § 1071 to allow it to apply the principles of I.R.C. § 1033 for [redacted]'s sale of [redacted].

To qualify for nonrecognition under I.R.C. § 1033(a)(2), gain must be realized from an involuntary conversion and the proceeds from the conversion must be used to purchase replacement property within the 2-year replacement period. The taxpayer claims that [redacted]'s purchase of [redacted] Class A common stock, Class B common stock, and preferred stock from [redacted] on [redacted] constitute the purchase of replacement property with proceeds from the sale of [redacted].

Looking at the transaction between [redacted] and [redacted] in isolation, [redacted] purchased a controlling interest in [redacted] from [redacted] within the required two-year period for $[redacted]. The IRS accepts that [redacted] is qualified replacement property for [redacted]. The taxpayer reported the difference between the $[redacted] purchase price of the replacement property and the $[redacted] proceeds from the sale of [redacted] as gain. On its face, the purchase of [redacted] for $[redacted] would qualify to allow that portion of the gain realized by [redacted] on the sale of [redacted] for nonrecognition, as reported by the taxpayer.

A purchase of replacement property from a related parties can qualify as a purchase of replacement property under I.R.C. § 1033.[6] Rev. Rul. 73-120, 1973-1 C.B. 369. However, the transaction between the related parties must be a bona fide purchase at arm's length and not a sham. Templeton v. Commissioner, 66 T.C. 509 (1976), on reh'g, 67 T.C. 518 (1976), aff'd per curiam, 573 F.2d 866 (4th Cir. 1978); American Truck Rental Corp. v. Commissioner, T.C. Memo. 1965-9, aff'd, 355 F.2d 928 (3rd Cir. 1966), cert. denied, 385 U.S. 815 (1966). Further more, when a complex series of transactions is entered into the step transaction doctrine requires that the "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction." Commissioner v. Clark, 489 U.S. 726, 738 (1989) (quotation marks and citations omitted). The overall substance of the transaction controls over the form. [redacted]'s purchase of [redacted] stock from [redacted] will qualify as a replacement only if: 1) the transaction is a bona fide arm's length transaction, not a sham, and 2) the step

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[6] For involuntary conversions after February 6, 1995, this is limited by I.R.C. § 1033(i), which requires replacement property to be acquired from an unrelated party in certain cases.

transaction doctrine does not apply to disregard the intermediate step taken to increase the purchase price of [redacted] to $[redacted].

We will address the step transaction doctrine first. Courts have developed three tests to determine whether the step transaction doctrine should apply to collapse the individual steps of a transaction: 1) the end result test, 2) the interdependence test, and 3) the binding commitment test. If the circumstances satisfy any one of these tests, the step transaction doctrine applies. True v. United States, 190 F.3d 1165, 1174-75 (10th Cir. 1999).

Under the end result test, if a series of closely related steps in a transaction are merely means to reach a particular result, it will be treated as a single transaction, rather than a series of steps. The taxpayer's intent is relevant to determine whether the series of transactions was intended to reach a particular result. The intent focused on is not whether the taxpayer intended to avoid taxes, but whether the taxpayer intended to reach a specific result by structuring the transaction in a certain way. Id. at 1175.

Under the interdependence test, if it is unlikely that any one step would have been undertaken except in contemplation of the other integrated acts, the tax effects of the individual steps will be ignored. This test focuses on the relationship between the individual steps and whether objectively the steps were so interrelated that one transaction seems fruitless without completion of the series. Id. at 1175.

Under the binding commitment test separate steps will be combined if, upon taking the first step, there is a binding commitment to take the next step. Security Industries Insurance Co. v. United States, 702 F.2d 1234, 1245 (5th Cir. 1983).

While the presence of a business purpose for multiple steps in a transaction does not preclude application of the step transaction doctrine, the absence of a business purpose for the steps may require those steps to be ignored under the step transaction doctrine. True, at 1176-77; Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1526-27 (10th Cir. 1991).

The multiple steps taken in this case can be ignored under either the end result test or the interdependence test of the step transaction doctrine. The entire series of transactions appears to be aimed solely at transferring a [redacted] to [redacted] for $[redacted]. The intermediate steps were taken solely to support the ultimate purchase price of $[redacted]. It also appears unlikely the intermediate steps to boost the purchase price to $[redacted] would have been taken except in concert with the other steps.

In substance, [redacted] acquired control of [redacted] from [redacted] as required by the shareholders' agreement. [redacted] then transferred control of [redacted] to [redacted] for the nominal amount of $[redacted] ($[redacted] per share). The intervening step between [redacted], [redacted], [redacted] and [redacted] that increased the apparent purchase price by $[redacted] should be disregarded. The true value of [redacted] was no more than the nominal $[redacted] per share at which the common stock was transferred between [redacted], [redacted] and [redacted].

Before the transaction, [redacted] had assets with a $[redacted] value and owed $[redacted], giving it a negative net asset value of $[redacted]. [redacted] had reported losses for its entire history, so it does not appear to have any goodwill or going concern value. At best, [redacted] had only nominal value before the transaction. This supports the transfer of common stock at $[redacted] per share between [redacted], [redacted] and [redacted] as an arm's length price.

In the integrated transaction on [redacted] $[redacted] of [redacted]'s debt was recharacterized from debt to equity and $[redacted] was written off, leaving [redacted] with only $[redacted] of debt. [redacted] assumed $[redacted] of debt, through it wholly owned subsidiary [redacted], in exchange for a deemed capital contribution. [redacted] forgave $[redacted] of the debt and reclassified $[redacted] of the debt into equity by exchanging it for newly issued preferred stock. These simultaneous transactions (all of which were essentially bookkeeping entries between related parties, with no money actually changing hands) left [redacted] with only $[redacted] of debt shown on its books. With assets valued at $[redacted], this allowed [redacted] to show sufficient equity on its books to support the issuance of $[redacted] of preferred stock. [redacted] obtained $[redacted] of preferred stock in exchange for $[redacted] of debt due from [redacted], and simultaneously transferred the $[redacted] of preferred stock for $[redacted] of debt due from [redacted]'s new parent. This left [redacted] in essentially the same position before and after the transaction.

The assumptions of debt by [redacted]'s first and second tier parents and the conversion of debt to preferred stock by [redacted]s third tier parent (and simultaneous transfer of that stock for debt) had no apparent purpose other than to artificially inflate the price [redacted] paid for [redacted]. The intent of these transactions seems to be to reach the end result of a $[redacted] purchase of a [redacted] company by [redacted]. Moreover, it appears unlikely that the debt assumptions and conversion of debt into preferred stock would have occurred unless [redacted] acquired [redacted] at an increased price because of these transactions.

The step transaction doctrine can be applied in this case under either the end result test or the interdependence test to ignore the debt assumptions and conversion of debt into preferred stock. [redacted] should be deemed to have purchase control of [redacted] by purchasing the Class A and Class B common stock for $[redacted] per share, or a total of $[redacted]. The additional $[redacted] that the taxpayer claims was paid in this acquisition was artificially created by transactions within the control group that had no economic substance.

The only money that actually changed hands in the [redacted], transactions was the $[redacted] that [redacted] paid to [redacted] for the [redacted] Class A shares and the $[redacted] that [redacted] paid [redacted] for [redacted] Class A shares and [redacted] Class B shares. The remainder of the transactions consisted of book entries and the shuffling of papers between related entities to convert a company with a negative net worth into a company that seemed to be worth $[redacted]. This was done to justify [redacted]'s purchase at this price for no apparent reason other than tax benefits. The $[redacted] purchase price was financed through the shifting of intercompany debts within the control group. This was simply an internal corporate restructuring of the debt that was made to look like a $[redacted] acquisition.

For the same reasons that the step transaction doctrine applies, the transactions between related parties can be disregarded under I.R.C. § 1033. The transactions does not have the indicia of a bona fide purchase at arm's length, rather than a sham. See A.A. Gallaghter Warehousing Corp. v. Commissioner, T.C. Memo. 1965-9. Essentially, $[redacted] of the note that [redacted] gave to [redacted] to acquire the newly issued preferred shares of [redacted] merely replaced the pre-existing $[redacted] of debt that [redacted] owed to [redacted] and which [redacted] exchanged for the preferred stock. As in A.A. Gallagther Warehousing Corp., "the transaction in question did not constitute a bona fide stock purchase within the intendment of section 1032(a)(3)(A) of the Code and amounted to no more than a mere sham transaction."

The payment history on the notes to [redacted] resulting from the [redacted], transactions, particularly the payment history on those notes as a result of and subsequent to the sale of [redacted] could further support the position that the transactions were shams, lacking economic substance. If the later facts indicated that the notes were nonrecourse notes, payable only out of income generated by or gain from the disposition of [redacted] or its assets, the governments position would be strengthened.

If you have any questions in this matter, please feel free to contact me.

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By:________________________
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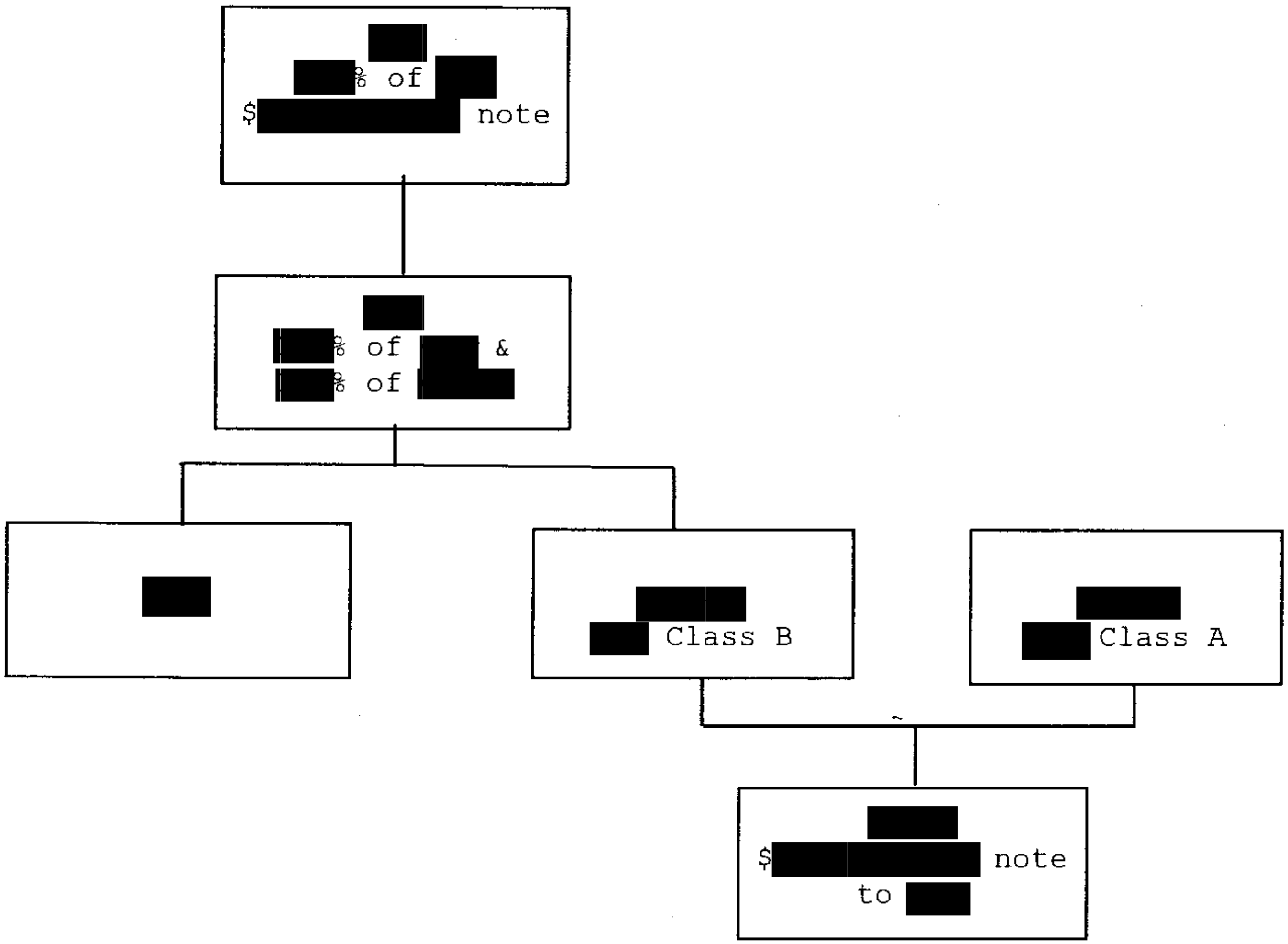
Before the [redacted] Transaction



After the [redacted] Transaction

[redacted]
[redacted]% of [redacted]
$[redacted] note
from [redacted]
$[redacted] note
from [redacted]
$[redacted] note

[redacted]
[redacted]% of [redacted] &
[redacted]% of [redacted]
$[redacted] note
to [redacted]

[redacted]
[redacted] Class A

[redacted]
[redacted] Class A
[redacted] Class B
$[redacted] Preferred
$[redacted] note
to [redacted]

[redacted]

[redacted]
$[redacted] note
to [redacted]